



STATE OF TENNESSEE
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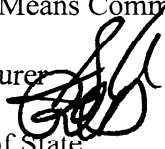
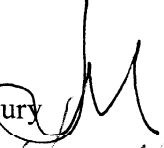


May 9, 2002

Memorandum

TO: The Honorable Don Sundquist
Governor

The Honorable Douglas Henry, Jr., Chairman
Senate Finance, Ways, & Means Committee

The Honorable Matt Kisber, Chairman
House Finance, Ways, & Means Committee

FROM: Steve Adams, State Treasurer 
Riley Darnell, Secretary of State 
John Morgan, Comptroller of the Treasury 
Warren Neel, Ph.D., Commissioner
Department of Finance & Administration 

SUBJECT: Revision to Revenue Estimates for FY 2001-02 and FY 2002-03

The State Funding Board met at 9:30 a.m. on May 8, 2002 in Room 16 of the Legislative Plaza for the purpose of considering whether the consensus ranges of revenue estimates previously recommended by the Board should be modified. During this meeting, the Board heard testimony from Mr. James Davenport of the Fiscal Review Committee and Dr. William Fox of the University of Tennessee, Knoxville. The revenue estimates provided by each of the presenters are summarized in the attachments to this memorandum. The Board re-convened at 4:00 pm to finalize its deliberations. The consensus revenue ranges contained in this memorandum update and replace those transmitted to you on December 18, 2001.

Commissioner Neel presented the final revenue collections for April, 2002. These figures show that April collections continued to exhibit the same collection patterns seen throughout the year. The report indicates that year-to-date collections for the franchise, excise, income, and sales taxes continue to undercollect when compared to

the original estimates and, in fact, collections for the franchise, excise, and income taxes have experienced negative year-to-date collections. Sales tax collections have "rebounded" to exhibit positive growth for April, 2002 and year to date, but still are considerably below budgetary estimates.

Dr. Fox presented an economic overview, information on employment growth, levels of unemployment, and consumption spending. It was noted that the recent economic downturn was a "business" rather than a "consumer" recession. Essentially, CY 2001 saw decreased levels of investment and inventories by businesses, with levels of consumer spending, while reduced, still experiencing growth. As a consequence, the opportunity for growth going forward will likely be driven by a turnaround in the level of business investment spending. In terms of "threats" to the national economic recovery, the following factors were noted: disruption in oil supplies and its impact on all sectors of the economy; stock market underperformance (versus consumer expectations) and its consequent impact on reducing levels of consumer spending; and the political situation in the Mideast. All this results in an economic forecast that envisions a modest economic recovery with a remote opportunity for a "double dip" recession. The Board noted that yesterday's action by the Federal Reserve Bank to maintain short term interest rates at a negative level (when adjusted for inflation) indicates the Fed continues to be concerned with an economy that is sluggish and in danger of sliding backward. It was also noted that when interest rates begin to rise, the cost of financing vehicle and home purchases becomes more expensive. This will impact the sales tax collections to the extent that rising interest rates impact consumption. Mr. Davenport, in his presentation, stated his agreement with Dr. Fox's analysis of the economy.

The Board also discussed the performance of the State's excise tax. Dr. Fox noted that excise tax underperformance is a national phenomenon that can only partially be attributed to reduced levels of corporate profits. Also at play are factors such as aggressive tax planning, federal actions that impact levels of federal taxable income (to which Tennessee is basically coupled), increased levels of tax evasion, and levels of tax incentives given by states. A general discussion of alternatives to address this situation took place, with a conclusion that absent action by the state continued erosion of the excise tax should be expected. Dr. Fox summarized by stating that the state is now faced with the prospect of an increasing structural problem in its tax system due to both the historic inelasticity of the sales tax and the increasing excise tax problems outlined above.

As to FY 2001-02, all presenters expect the State to undercollect the original budget estimates. Estimated annual growth rates among presenters were consistent with each other. The level of undercollection versus the original budget estimates range from \$430.8 to \$438.3 million in total and \$399.0 to \$403.6 million in the general fund. Again, for FY 2002-03, both presenters' growth rates for the major tax types were comparable, with the exception of the sales tax. For the sales tax, Dr. Fox's estimate of 4.0% growth is one percent higher than the Fiscal Review Committee estimate and is based on an assumption that levels of business investment activity will recover later in CY 2002. Presenters were asked to identify the risks to their current estimates of

revenue. Both presenters base their current forecasts on the assumption that a modest economic recovery will occur during FY 2002. As noted earlier, Dr. Fox's assumption of a recovery in business investment activity during the last half of CY 2002 is an important factor in achieving his estimates.

As a final note, each presenter believed their estimate of revenue growth to be reasonable, however, there was general agreement by the presenters that the use of growth rates in excess of those discussed would expose the state to a significant risk of undercollection and that the use of more conservative estimates are appropriate for purposes of state budgeting. This is especially true given the "recovery" assumptions underlying these estimates and the state's current fiscal condition. The Board would echo those comments. It is inevitable that the state must use practically all of its reserve funds to balance the budget for the current year. This will result in minimal liquidity going into FY 2002-03. Without reserves being available in the new year to cushion the blow of any revenue shortfall, the state would be forced to implement immediate spending reductions to maintain a balanced budget.

Based on the testimony received, the Board concludes that it is appropriate to modify the consensus revenue ranges which were transmitted on December 18, 2001 as follows:

	FY 2001-02		FY 2002-03	
	Low	High	Low	High
Total State Taxes	(3.75)%	(3.50)%	1.90%	2.40%
General Fund Only	(3.95)%	(3.70)%	1.80%	2.30%

The FY 2001-02 revenue estimate contained in the budget as introduced anticipated a reduction of \$308.6 million for total taxes and \$298.5 million for the general fund. Based on these estimates, the additional total revenue undercollection would range from \$132.2 million to \$151.4 million. The corresponding additional general fund undercollection would range from \$106.1 million to \$ 121.5 million.

The Board believes these consensus revenue growth ranges to be reasonable and appropriate for use in state budgeting.

Each of the us stands ready to discuss this further at your convenience.

Attachment

cc. The Honorable John S. Wilder
The Honorable Jimmy Naifeh

**COMPARISON OF ESTIMATED STATE TAX REVENUE FOR
FISCAL YEAR 2001-2002**

(Accrual - Basis Estimates)

2001-2002									
DEPARTMENT OF REVENUE	2000-2001	7/1/2001		2002-03		5/8/2002		5/8/2002	
SOURCE OF REVENUE	ACTUAL	BUDGETED		BUDGET DOCUMENT		ESTIMATE		ESTIMATE	
	COLLECTIONS	ESTIMATE	% Change	ESTIMATE	%	DR. FOX	% Change	FISCAL REVIEW	% Change
Sales and use Tax	\$4,643,337,500	\$4,785,700,000	3.07%	\$4,619,500,000	-0.51%	\$4,656,900,000	0.29%	\$4,643,783,000	0.01%
Gasoline Tax	569,421,100	578,000,000	1.51%	578,000,000	1.51%	563,700,000	-1.00%	567,505,000	-0.34%
Motor Fuel Tax	173,417,700	149,700,000	-13.68%	151,000,000	-12.93%	150,000,000	-13.50%	150,056,000	-13.47%
Gasoline Inspection Tax	61,486,900 *	63,100,000	2.62%	63,500,000	3.27%	61,000,000	-0.79%	61,296,000	-0.31%
Motor Vehicle Registration Tax	211,427,600	218,500,000	3.35%	218,500,000	3.35%	230,000,000	8.78%	223,500,000	5.71%
Income Tax	199,397,100	204,800,000	2.71%	204,500,000	2.56%	148,000,000	-25.78%	146,533,000	-26.51%
Privilege Tax - Less Earmarked Portion (1)	160,766,200 (1)	166,700,000	3.69%	166,300,000	3.44%	178,300,000	10.91% (1)	176,365,000	9.70%
Gross Receipts Tax - TVA	226,334,500	198,300,000	-12.39%	200,300,000	-11.50%	199,900,000	-11.68%	199,470,000	-11.87%
Gross Receipts Tax - Other	22,266,400	23,300,000	4.64%	23,300,000	4.64%	23,200,000	4.19%	23,100,000	3.74%
Beer Tax	15,476,600 *	16,200,000	4.67%	16,100,000	4.03%	15,800,000	2.09%	16,099,000	4.02%
Alcoholic Beverage Tax	30,043,100 *	31,000,000	3.19%	31,000,000	3.19%	31,000,000	3.19%	31,075,000	3.43%
Franchise & Excise Taxes	1,102,801,300	1,150,200,000	4.30%	1,000,000,000	-9.32%	890,000,000	-19.30%	905,000,000	-17.94%
Inheritance and Estate Tax	89,676,300 *	91,150,000	1.64%	95,400,000	6.38%	98,000,000	9.28%	94,100,000	4.93%
Tobacco Tax	82,814,000 *	82,600,000	-0.26%	82,600,000	-0.26%	82,500,000	-0.38%	82,680,000	-0.16%
Motor Vehicle Title Fees	10,646,700 *	10,800,000	1.44%	11,100,000	4.26%	10,600,000	-0.44%	10,671,000	0.23%
Mixed Drink Tax	34,334,500 *	35,800,000	4.27%	36,100,000	5.14%	36,000,000	4.85%	35,867,000	4.46%
Business Tax	21,509,100 *	22,400,000	4.14%	22,300,000	3.68%	22,300,000	3.68%	22,653,000	5.32%
Severance Tax	1,140,700 *	1,000,000	-12.33%	1,100,000	-3.57%	1,100,000	-3.57%	1,150,000	0.82%
Coin Operated Amusement Tax	58,500 *	-	-100.00%	-	NA	100,000	70.94%	50,000	-14.53%
All Other Taxes	-	-	NA	-	NA	-	NA	-	NA
TOTAL DEPARTMENT OF REVENUE	\$7,656,355,800	\$7,829,250,000	2.26%	\$7,520,600,000	-1.77%	\$7,398,400,000	-3.37%	\$7,390,953,000	-3.47%
GENERAL FUND ONLY (2)	\$6,143,510,200	\$6,320,850,000	2.89%	\$6,022,300,000	-1.97%	\$5,921,800,000	-3.61%	\$5,917,253,000	-3.68%
Budgeted Est. Compared to New Est. - Total				-\$308,650,000		-\$430,850,000		-\$438,297,000	
Budgeted Est. Compared to New Est. - Gen. Fund				-\$298,550,000		-\$399,050,000		-\$403,597,000	
SELECTED TAXES	ACTUAL	BUDGETED	%	F&A	%	DR. FOX	%	FISCAL REVIEW	%
SALES AND USE TAX	\$4,643,337,500	\$4,785,700,000	3.07%	\$4,619,500,000	-0.51%	\$4,656,900,000	0.29%	\$4,643,783,000	0.01%
FRANCHISE AND EXCISE TAXES	1,102,801,300	1,150,200,000	4.30%	1,000,000,000	-9.32%	890,000,000	-19.30%	905,000,000	-17.94%
ALL OTHER TAXES	1,910,217,000	1,893,350,000	-0.88%	1,901,100,000	-0.48%	1,851,500,000	-3.07%	1,842,170,000	-3.56%

(1) Privilege Tax estimates are reduced by \$31,700,000 in 2001-2002 for the earmarked portion of the tax.

(2) F&A calculated the General Fund distribution for all presenters.

**COMPARISON OF ESTIMATED STATE TAX REVENUE FOR
FISCAL YEAR 2002-2003**

(Accrual - Basis Estimates)

2002-2003						
DEPARTMENT OF REVENUE	2002-03		5/8/2002		5/8/2002	
	BUDGET DOCUMENT		ESTIMATE		ESTIMATE	
SOURCE OF REVENUE	ESTIMATE	%	DR. FOX	% Change	FISCAL REVIEW	% Change
Sales and use Tax	\$ 4,781,200,000	3.50%	\$ 4,843,200,000	4.00%	\$ 4,783,096,000	3.00%
Gasoline Tax	586,600,000	1.49%	572,200,000	1.51%	576,018,000	1.50%
Motor Fuel Tax	156,300,000	3.51%	155,300,000	3.53%	154,558,000	3.00%
Gasoline Inspection Tax	64,800,000	2.05%	62,200,000	1.97%	62,828,000	2.50%
Motor Vehicle Registration Tax	227,200,000	3.98%	239,200,000	4.00%	231,323,000	3.50%
Income Tax	214,700,000	4.99%	162,800,000	10.00%	153,860,000	5.00%
Privilege Tax - Less Earmarked Portion (1)	171,900,000	3.37%	184,300,000 (1)	3.37%	183,420,000	4.00%
Gross Receipts Tax - TVA	202,300,000	1.00%	204,000,000	2.05%	203,459,000	2.00%
Gross Receipts Tax - Other	24,400,000	4.72%	24,300,000	4.74%	23,909,000	3.50%
Beer Tax	16,300,000	1.24%	16,000,000	1.27%	16,260,000	1.00%
Alcoholic Beverage Tax	31,800,000	2.58%	31,500,000	1.61%	31,697,000	2.00%
Franchise & Excise Taxes	1,025,000,000	2.50%	890,000,000	0.00%	900,000,000	-0.55%
Inheritance and Estate Tax	90,000,000	-5.66%	95,000,000	-3.06%	92,100,000	-2.13%
Tobacco Tax	82,600,000	0.00%	82,500,000	0.00%	82,680,000	0.00%
Motor Vehicle Title Fees	11,300,000	1.80%	10,800,000	1.89%	10,884,000	2.00%
Mixed Drink Tax	37,100,000	2.77%	37,300,000	3.61%	36,764,000	2.50%
Business Tax	23,200,000	4.04%	23,200,000	4.04%	23,333,000	3.00%
Severance Tax	1,100,000	0.00%	1,100,000	0.00%	1,150,000	0.00%
Coin Operated Amusement Tax	-	NA	100,000	NA	50,000	0.00%
All Other Taxes	-	NA	-	NA	-	NA
TOTAL DEPARTMENT OF REVENUE	\$ 7,747,800,000	3.02%	\$ 7,635,000,000	3.20%	\$ 7,567,389,000	2.39%
GENERAL FUND ONLY (2)	\$ 6,206,300,000	3.06%	\$ 6,111,200,000	3.20%	\$ 6,053,489,000	2.30%
Growth over FY 02 Budgeted Est. - Total	-\$81,450,000		-\$194,250,000		-\$261,861,000	
Growth over FY 02 Budgeted Est. - Gen. Fund	-\$114,550,000		-\$209,650,000		-\$267,361,000	
SELECTED TAXES	F&A	%	DR. FOX	%	FISCAL REVIEW	%
SALES AND USE TAX	\$ 4,781,200,000	3.50%	\$ 4,843,200,000	4.00%	\$ 4,783,096,000	3.00%
FRANCHISE AND EXCISE TAXES	1,025,000,000	2.50%	890,000,000	0.00%	900,000,000	-0.55%
ALL OTHER TAXES	1,941,600,000	2.13%	1,901,800,000	2.72%	1,884,293,000	2.29%

(1) Privilege Tax estimates are reduced by \$32,000,000 in 2002-2003 for the earmarked portion of the tax.

(2) F&A calculated the General Fund distribution for all presenters.